Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1974

No. 75-153

LAND O'LAKES, INC., formerly LAND O'LAKES CREAMERIES, INC., a Minnesota corporation,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION OF LAND O'LAKES, INC. FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PRAYER FOR WRIT AND NATURE OF CASE

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eight Circuit which reversed a judgment entered in the United States District Court for the District of Minnesota (Third Division, St. Paul, Minnesota) in favor of petitioner for $254,987.74 (including interest), refund of income taxes for the year 1963.

CITATIONS OF OPINIONS BELOW

The opinion of the District Court is reported in 362 F.Supp. 1253 and is set forth in Appendix A hereof at page A-1. The opinion of the Court of Appeals is not yet reported. Said opinion is set forth in Appendix B hereof at page B-1.

JURISDICTION

The judgment of the Court of Appeals sought to be reviewed was entered April 30, 1975. No petition for rehearing was filed. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Shall a farmers' cooperative association, one of the largest in the nation, servicing over 100,000 farmers, have its tax exempt status under section 521(b) of the Internal Revenue Code revoked because during the tax year in question it engaged in certain non-exempt activities which the trial court found to be "merely incidental" and done for purpose of furthering the exempt activities; and because the patronage dividends arising from such incidental activity were channeled to the farmers?

STATUTES INVOLVED

The portions of Section 521(b) of the Code relevant to this case read thus:

"(1) Exempt farmers' cooperatives. The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) [26 U.S.C. § 521(a)] are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by the, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."

* * * *

"(4) Transactions with nonmembers. Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."

The portions of the Internal Revenue Code relevant to the question of patronage read thus:

Section 1388(a)—

"For purposes of this subchapter, the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies—

"(1) on the basis of quantity or value of business done with or for such patron,

"(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

"(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons."

STATEMENT OF THE CASE

Petitioner, hereafter referred to as "Land O'Lakes", has been exempt from income taxes continuously from 1923 up to 1970 when its exemption was revoked retroactively as of January 1, 1963 by action of the Commissioner of Internal Revenue. Land O'Lakes paid the tax deficiency assessed for that year and sued for refund. The case was tried by the Court without a jury, Judge Edward J. Devitt, Chief Judge, presiding. District Court jurisdiction was based upon 28 U.S.C. 1346.

No issue was raised as to the organization of Land O'Lakes, but only as to certain of its activities. It had both individual farmers as members, and local farmers' cooperative associations, principally local creameries. Its primary activity was marketing of dairy and poultry products of its farmer-members and farmer-patrons located in the upper midwest. The greater portion of these products were sold at wholesale from

branch warehouses owned and operated by Land O'Lakes in the principal cities of the nation east of the Rocky Mountains, to food stores (large ones and small ones), to institutions, hotels, restaurants, etc. In many of the large cities Land O'Lakes made wagon sales operating out of the branch warehouses. It was in competition with the principal proprietary corporations doing a similar business, such as Kraft Foods Company, Borden Company, Beatrice Foods and others.[1]

The products marketed by Land O'Lakes were obtained in raw form from its farmer-members or farmer-patrons and proceessed into finished commodities either in local creamery plants or cheese plants or in centralized plants owned and operated by Land O'Lakes. The entire net earnings derived from such activity were distributed to the farmers on a patronage basis, both member-farmers and non-member farmers alike.

In order to sell its products at wholesale in the markets where it was doing business, it was necessary for Land O'Lakes on some occasions to include specialty items not obtainable from its own farmers, limited to special types of cheese, butter, eggs and poultry. Such items were obtained from proprietary companies (companies which were not farmers' cooperatives). The sideline items were obtained only intermittently because there were instances where Land O'Lakes in order to sell its own butter and cheese and turkeys had to furnish the customer said items. The specialty items in 1963 aggregated 3.4% of total wholesale sales. Under Land O'Lakes' charter and by-laws, and local law as interpreted by

[1] Land O'Lakes sold some products at retail which business was local in nature and relatively small, consisting of house-to-house milk routes and ice cream stores. Although the Government contended that the retail business violated the exemption rules of the Code (selling some products not obtained from farmers in the ice cream stores) the Court of Appeals gave no consideration to that matter.

its counsel, it was required to include the proprietary companies from whom the items were purchased in its distribution of patronage dividends. It was deemed by Land O'Lakes that the sideline business was done *for* the farmers to better market their products, and since it was done for them the patronage should go to them under the Code provisions. To achieve that purpose the sideline items were purchased through a wholly-owned subsidiary, Northwest Dairy Products Company, Inc., a business corporation, to whom the patronage was paid and thereafter returned to Land O'Lakes and paid to its farmers.

In addition to its marketing operations, Land O'Lakes also engaged in the agricultural supply business in a rather limited manner. This was a relatively small operation compared to the marketing operations and was keyed primarily to assisting the marketing operations. Its purpose was to furnish farmers delivering products to Land O'Lakes specialized types of animal feed, seed, fertilizer and other supplies designed to enhance the quality and quantity of their production. To do this Land O'Lakes owned and operated feed mills and fertilizer plants for manufacturing such feed and fertilizer.

Originally, and for a long period of time, these supplies were sold only at wholesale to local creamery cooperatives, and in some instances, to local farmers' cooperative elevators. In course of time local creameries vanished and were replaced by centralized dairy plants, and the farmers' milk was collected by tank trucks covering long distances. As a consequence gaps existed where no inventory of feed and fertilizer was available to farmers delivering products to Land O'Lakes and needing Land O'Lakes feed, seeds and fertilizers. To meet the situation Land O'Lakes set up its own feed stores in certain areas, selling supplies directly to farmers at retail. These stores proved to be uneconomical. Their operation resulted in

net loss to the cooperative. As a solution Land O'Lakes contracted with proprietary feed dealers who were mainly small, individual operators in country towns, to whom supplies were sold at wholesale on condition that the same would be sold only to farmers and all patronage dividends would be paid to the farmers. The arrangement was denominated as an "agent-buyer" agreement. By such arrangement the cooperative was relieved of having to maintain inventories in those areas. A one-man business could do so at less cost than a large corporation having to pay union wages. The trial court found as a fact that farmers who purchased their supplies from an agent-buyer paid the same retail price (the prevailing market price) as farmers who purchased supplies from Land O'Lakes' own feed store, and in both instances they received the same patronage dividend.[2] There were some areas where Land O'Lakes was unable to effect an agent-buyer agreement with a local feed dealer and in that case supplies were sold to such dealer without agreement. The farmers who purchased supplies from that dealer paid the same retail price as the others, but received no patronage dividend. The patronage dividend in that instance was paid to the dealer.

This so-called agent-buyer business represented a very small segment of the total operation. The trial court's findings of fact showed 82.4% of the supply business was done with local cooperatives or individual farmers, 9.3% was done with proprietary feed dealers, and 8.3% with agent-buyers. The Code provisions permit 15% of the supply business may be with persons who are neither "members or producers". The trial court held the agent-buyer arrangement was "permissible" within the Code and need not be counted against the allowable 15%.

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[2] The patronage dividend was a substantial item amounting to $150,935.09 on sales by agent-buyers to farmers in 1963.

The Court of Appeals reversed the lower court on three grounds:

(1) The agent-buyer arrangement was not a permissible activity within the provisions for exemption under the Code.

(2) The sale of specialty items obtained from proprietary companies in the wholesale marketing operations violated the provisions of the Code for exemption.

(3) The payment of patronage dividends to the subsidiary was in violation of the provisions of the Code for exemption.

REASONS FOR GRANTING THE WRIT

This case presents an important question of construction of a federal statute. Although the statute has existed in various forms for many years, it has not been previously construed by this court, nor in an authoritative way by lower courts.

1. IMPORTANCE OF THE QUESTION.

Although farmers' cooperatives have been granted tax exemption in one form or another by Congressional enactment continuously since the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Sec. IIG(a), this case presents the first time that an appeals court, or this court, ever construed that phase of the statute. Prior to this case there was virtually no judicial construction of that phase of the statute. Farmers' cooperatives represent an important segment of the nation's economy. In a publication entitled "Cooperative Growth" put out by the U. S. Department of Agriculture, Farmer Cooperative Service (FCS Information 87), dated March, 1973, it is stated on page 94 that about five out of six farmers are members of one or more cooperative associations, The net volume of cooperative business in 1969-70 was $19.0 billion (page 92).

In 1963 the Internal Revenue Service issued a publication entitled "Statistics of Income: Farmers' Cooperative Income Tax Returns," Publication No. 386 (11-66). On page 1 of said Publication it is stated that of 8,595 farmers' cooperative income tax returns examined for 1963, 5,574 were for exempt cooperatives. It is believed that this ratio (2/3rds exempt) is fairly representative of the situation today.

Continuously since 1941, and earlier, the Courts and the Commissioner have ruled without statutory sanction that an organization operating on a cooperative basis (not necessarily confined to farmers' organizations) may deduct patronage dividends when paid under a pre-existing enforceable obligation, on the theory such dividends are not income of the cooperative. *Midland Cooperative Wholesale vs. C.I.R.*, 44 B.T.A. 824 (1941); *U. S. vs. Mississippi Chemical Co.*, 326 F.2d 569 (C.A. 5, 1964). Despite such tax treatment of cooperatives generally, Congress has seen fit to grant exemption to those farmers' cooperatives whose membership is limited strictly to farmers' who are patronizing the association and who meet the other requirements specified by Congress, aimed to assure that they are bona fide farmers' organizations, and that the profits all go to the farmers on a patronage basis. Congress has done this to encourage and strengthen collective marketing and purchasing by farmers. There has always existed a substantial difference tax-wise between an exempt cooperative and a non-exempt cooperative. Usually the exempt cooperative pays virtually no income taxes. By the provisions contained in the Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, Sec. 17(a), Congress put into legislative enactment what had hitherto been the tax treatment afforded to the non-farmer cooperatives, or the non-qualifying farmers' cooperatives, cf.

S. Report on Rev. Act of 1962, U. S. Code Cong. and Admin. News, 87 Cong., Sec. Sess., pp. 3414-3417. Nevertheless, under the 1962 Revenue Act, there still exists significant tax benefits accruing to the exempt cooperative not available to the non-exempt cooperative.

In 1970 Land O'Lakes elected to change its status from an exempt cooperative to a non-exempt cooperative because it desired to pay patronage dividends only to its member-farmers based upon the business done with or for them, and pay no patronage dividends on the remainder of its business. This came about because of a radical change in the character of its business. This action was taken by Land O'Lakes before if had knowledge of the Commissioner's action revoking its exempt status retroactively to January 1, 1963. That action of Land O'Lakes does not detract from the significance of the issues in this case. Those issues affect Land O'Lakes substantially for seven years, and they affect thousands of farmers' cooperatives in the United States who find it desirable to retain their exempt status to this day.

2. THE EXEMPTION PROVISION SHOULD BE GIVEN A PRACTICAL CONSTRUCTION TO CARRY OUT THE INTENT OF CONGRESS.

The Court of Appeals in this case stated: "Statutory language exempting farmers' cooperatives from the full burdens of taxation is to be strictly construed." (Appendix B-8)

While there may be persuasive reasons to construe narrowly tax exemption provisions in general, the opposite situation applies here. After a period of many years of liberal construction by the Internal Revenue Service, Congress acknowledged that practice with approval. In the report of the Senate Finance Committee on Internal Revenue Bill of 1926,

S. Rep. No. 52, 69th Cong., 1st Sess., it is stated on pages 23-24 thus:

> ". . . the Treasury Department in its regulations has construed the existing law with great liberality . . . allowing such associations to manufacture their products, to change the form of raw materials, and in some cases to operate subsidiaries, so long as the operations are not conducted on an ordinary profit-making basis.
>
> ". . . The amendment will assure associations, now exempt, that the liberal construction, by the department, of existing law is sanctioned by Congress . . . ." (pp. 23-(24.)

Section 521 should be viewed in the larger context of Subchapter F of Chapter One of the Internal Revenue Code of 1954 which deals with exempt organizations. Section 501(c) gives a list of exempt organizations such as civic leagues, business leagues, social clubs, and the like. Although there have been virtually no judicial constructions as to the scope of activity permissible under Section 521, there have been innumerable decisions by Courts of Appeals construing the exemption for other organizations. In every case such courts have construed the exemption thus: If the challenged non-exempt activity is merely incidental and is for the purpose of aiding the exempt activity, it will not defeat the exemption: *Commissioner v. Chicago Graphic Arts Fed.*, 128 F.2d 424 (C.A. 7, 1942); *Retailers Credit Ass'n. v. Commissioner*, 90 F.2d 47 (C.A. 9, 1937); *Crooks v. Kansas City Hay Dealers' Assn.*, 37 F.2d 83 (C.A. 8, 1929); *Texas Mobil Home Ass'n. v. C.I.R.*, 324 F.2d 691 (C.A. 5, 1963); *U. S. v. Omaha Live Stock Traders Exchange*, 366 F.2d 749 (C.A. 8, 1966); *Evanston-North Shore Board of Realtors v. U. S.*, 320 F.2d 375 (Ct. Cl.

1963) *Koon Kreek Klub v. Thomas*, 108 F.2d 616 (C.A. 5, 1939); *Scofield v. Corpus Christi Gulf & Country Club*, 127 F.2d 452 (C.A. 5, 1942); *Northwest Agricultural Cooperative Ass'n., Inc. v. Interstate Commerce Commission*, 350 F.2d 252 (C.A. 9, 1965); *Atlantic Coast Distributors v. Commissioner*, 33 F.2d 733 (C.A. 4, 1929).

Most of these decisions cited the decision of this Court in *Trinidad v. Sagrada Orden*, 263 U. S. 578 (1924)wherein this Court applied a similar construction to the exemption given to a religious organization, holding that the non-exempt activity was incidental.[3] The cases above cited pertained principally to business leagues and social clubs and like exempt organizations. As to these other organizations Congress used the word "exclusively" in describing the activity which would afford exemption. As to farmers' cooperatives that word is omitted. The exemption is granted to farmers' cooperatives which are organized and operated "*for the purpose*" of marketing the farmers' products and returning the net income to them, or purchasing supplies for the use of farmers and turning over to them such supplies at cost, plus necessary expenses. Congress used the word "purpose". The trial court construed the statute to mean that if the *purpose* of the challenged activity was to aid the exempt activity and was incidental thereto, the exemption should not be denied.

Both of the challenged activities were relatively small and confined to specific situations. As to agent-buyers the *purpose* was to have an inventory of supplies out in the country accessible to the farmers, which they would be able to obtain

[3] The only case of any consequence construing this phase of Section 521 is *Eugene Fruit Growers Ass'n. v. Comm.*, 37 B.T.A. 993 (1938), where the non-exempt activity was proportionably greater than the case at bar, but the exemption was sustained, citing this Court's decision in *Trinidad*.

at the same cost to them as the farmers buying from the cooperative's own store, and at the same time eliminate the loss incurred in having the cooperative maintain its own store. The profits arose from the manufacturing of the feed and fertilizer and those profits went to these farmers the same as to the other farmers. The facts showed that the agent-buyers got for themselves only "labor-income" (R. p. 203). The trial court looked at the "*purpose*" of the arrangement and concluded that the purpose was within the statute, to turn over the supplies to these particular farmers in this particular situation "at cost, plus necessary expenses".

As to the handling of sideline items in the wholesale marketing operation, the trial court looked at the "*purpose*" and concluded it was in aid of the marketing of the farmers' products and necessary to that end, and was incidental thereto, and, therefore, not violative of the applicable rules for exemption set forth in Section 521.

As indicated above, the Internal Revenue Service itself has throughout the years of administration of the statute given it a liberal construction, and Congress has approved that policy.

As late as 1967 the Commissioner issued Rev. Proc. No. 37 (Cum. Bull. 1967-2, pp. 668-669) wherein he allowed for retail marketing of products not obtained from farmers up to 5%, and beyond 5%, where such sales "constitute a necessary supplement to the efficient marketing of producer items", without loss of the exemption. No ruling has been made as to wholesale marketing operations, but there seems no basis for distinction of wholesale marketing and retail marketing.

The narrow construction applied by the Court of Appeals in the case at bar is contrary to the intent of Congress and thwarts the true meaning of the statute.

The Court of Appeals did not give consideration to whether the *purposes* of these challenged activities were within the purposes stated in the statute. It looked only at the activities themselves. It viewed the agent-buyer arrangement from a strictly legal point of view, testing whether Land O'Lakes could enforce collection of the price for which it sold the products to the agent against the agent's principal. That was not the issue at all.

The issue was whether the purpose of the activity was within the purpose stated in the statute. The Court of Appeals determined that an exempt cooperative cannot remain exempt if it sells *any* sideline items *whatsoever*, regardless of the purpose. This greatly diminishes the value of the exemption. It defeats the object of the exemption because it hampers rather than strengthens the farmers' position in the market place. Under this decision Land O'Lakes could not sell the products of its farmers effectively and retain its exemption. It could not supply feed, seed and fertilizer to those particular groups of farmers who were part of its cooperative enterprise at the same cost to them as to the other farmers. The construction given by the Court of Appeals is impractical.

The effect of this decision on Land O'Lakes is likewise the effect it will have on the five thousand farmers' cooperatives located throughout the United States who are endeavoring to maintain exempt status.

The consequences of this decision is that while other exempt organizations such as business leagues, social clubs and similar organizations enjoy a liberal construction of the tax exemption granted to them, enabling them to fully accomplish their purposes under the exemption, the farmers' cooperatives on the other hand who represent a vastly greater and more significant segment of our national life, are denied a practical con-

struction of their tax exemption which will enable them to function adequately under the exemption. This result ought not to be permitted to stand.

One of the essential requirements of a farmers' cooperative is that the earnings of the enterprise are distributed to the patrons on a cooperative basis. That is implicit in Section 521 although not spelled out in that section. In the 1962 amendment of the Code, Congress defined patronage dividend thus:

26 U.S.C. §1388(a)—

> "For the purpose of this subchapter the term 'patronage dividend' means an amount paid to a patron . . . on the basis of the quantity or value of business done with or for such patron . . . ."

Treasury Regulation 1.1388-1(e) defines a patron thus:

> "The term 'patron' includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association."

The handling of sideline items in the wholesale marketing operation was done *for* the farmers, to more effectively market their products, and the patronage should go to the farmers. The trial court found and determined that the payment of patronage to the subsidiary (Northwest Dairy Products Company, Inc.) was simply the means used to channel the patronage to the farmers and was within Section 1388 of the Code. The Court of Appeals in holding that the payment of patronage to the subsidiary, "a non-producer," violated the exemption, refused to acknowledge the substance of the transaction.

CONCLUSION

Because the case at bar represents the first judicial construction of the statute for all practical purposes, and because it pertains to the operations of over five thousand farmers' cooperative associations, representing several million farmers, and because the narrow construction of the statute rendered by the Court of Appeals substantially nullifies the exemption, we urge that this petition be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

3-71-Civ-49

LAND O'LAKES, INC., formerly
LAND O'LAKES CREAMERIES, INC.,
a Minnesota corporation,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

MEMORANDUM & ORDER

Doherty, Rumble & Butler, Harold Jordan and Irving Clark, St. Paul, Minnesota, attorneys for plaintiff.

Robert G. Renner, United States Attorney, Scott P. Crampton, Assistant Attorney General, Daniel J. Dinan, D. Patrick Mullarkey, and John A. Flanagan, attorneys, Department of Justice, attorneys for defendant.

In this civil tax refund action to recover $254,978.74 of income tax and interest paid for the calendar year 1963, the principal issue is whether plaintiff violated §521 of the Internal Revenue Code of 1954 and thus lost its qualification as a tax exempt organization. If the Court finds Land O'Lakes did

not qualify as a tax exempt organization for the year 1963, then numerous secondary issues which relate to deductions disallowed by the government must also be resolved. If the Court finds that Land O'Lakes did qualify as a tax exempt organization for the year 1963, then only one secondary issue which relates to deductibility must be resolved.

Land O'Lakes, Inc., a Minnesota corporation, is a farmers' cooperative which qualified as a tax exempt organization under §521 of the Code from 1923 through 1962. On February 9, 1970, the Internal Revenue Service notified Land O'Lakes by letter that the exemption of the farmers' cooperative was revoked effective with the calendar year 1963. On October 1, 1970 the I.R.S. notified Land O'Lakes of a proposed assessment of an alleged deficiency in income tax for the calendar year 1963 in the amount of $186,393.57. On November 2, 1970 Land O'Lakes paid the alleged deficiency plus interest of $68,585.17 for a total of $254,978.74 and filed a claim for refund. On December 30, 1970, the I.R.S. notified Land O'Lakes that its claim for refund was disallowed. Plaintiff instituted this action for refund on March 5, 1971.

The matter was tried to the Court on June 19 and 20, 1973. The parties stipulated to most of the facts. Briefs have been filed. Jurisdiction rests on 28 U.S.C. 1346.

The organizational structure of Land O'Lakes may be separated into two activities: (1) marketing activities and (2) supply activities. The marketing activities of Land O'Lakes were conducted by both retail and wholesale methods. The major portion of plaintiff's retail sales in 1963 was accomplished by Bridgeman Division. Bridgeman Division marketed both producer goods (dairy items) and nonproducer goods (nondairy items) at retail. The dairy items were supplied to Land O'Lakes by member-cooperatives and individual member-farmers (producers). The nondairy items were supplied to Land O'Lakes by proprietary companies (nonproducers). The major portion of Land O'Lakes' marketing activities in 1963 was accomplished by the wholesale method. In addition to marketing producer goods at wholesale, Land O'Lakes also marketed nonproducer goods at wholesale which were obtained from Northwest Dairy Products Company, Inc., a wholly-owned subsidiary. Northwest, a nonproducer, purchased the nonproducer goods from proprietary companies and sold the goods to plaintiff at cost. The supply activities of Land O'Lakes consisted of selling agricultural supplies to member-cooperatives, company stores, independent dealers, and agent-buyers who in turn resold the supplies to members and other patrons. The agent-buyer, a nonmember nonproducer, was used in geographical areas where Land O'Lakes did not have a member-cooperative or company store. Unlike the independent dealer, the agent-buyer executed an agreement with Land O'Lakes in which he agreed to provide the cooperative with all invoices based on sales of supplies to producers. At the end of each year, plaintiff distributed patronage dividends to all producers who purchased supplies from the agent-buyer as reflected by the invoices. The agent-buyer received patronage dividends attributable to purchases of supplies by nonproducers or by the agent-buyer himself.

The basic issue is whether Land O'Lakes was properly operating under the Internal Revenue Code as a tax exempt farmers' cooperative in 1963. To resolve this issue, the Court must analyze three sub-issues which involve the marketing and supply activities of Land O'Lakes. If the Court finds in favor of the government with regard to any one of the three sub-issues, then it must be concluded that plaintiff was improperly operating as a tax exempt organization for the calendar year 1963.

The first sub-issue is whether Land O'Lakes violated §521(b)(1)(A) of the Code by marketing nonproducer goods at retail through its Bridgeman Division. Section 521(b)(1)(A) provides that "farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either quantity or the value of the products furnished by them."

Neither the Code nor the Treasury Regulations promulgated thereunder make reference to the marketing of nonproducer goods by exempt farmers' cooperatives. The courts have held that tax exemption statutes should be strictly construed against the taxpayer. *See, e.g., Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U.S. 46 (1940); *Co-operative Grain & Supply Co. v. Commissioner of Internal Revenue*, 407 F.2d 1158 (8th Cir. 1969). However, there is also authority for the general proposition that tax exempt organizations may engage in certain "incidental activity which standing alone would be subject to taxation." *United States v. Omaha Live Stock Traders Exch.*, 366 F.2d 749, 752 (8th Cir. 1966), *quoting Evanston-North Shore Bd. of Realtors v. United States*, 320 F.2d 375, 380 (Ct. Cl. 1963). *See also Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924) (exempt religious organization); *Eugene Fruit Growers Ass'n v. Commissioner of Internal Revenue*, 37 B.T.A. 993 (1938) (exempt farmers' cooperative).

More specifically, the I.R.S. has ruled that an exempt farmers' cooperative may market nonproducer goods in two limited situations. The first exception allows an exempt farmers' co-

operative to market nonproducer goods in an emergency situation when necessary to fulfill outstanding orders based on pre-existing contractual commitments to facilitate dealings with member-patrons. Rev. Rul. 69-222, 1969-1 Cum. Bull. 161. This exception is not applicable here. The second exception allows an exempt farmers' cooperative to market nonproducer goods at retail if such goods are necessary to the effective marketing of producer goods. However, this exception is further limited by the requirement that the marketing of such nonproducer goods which are deemed "necessary" may not exceed five percent of the total retail sales unless the cooperative establishes that the total sales of nonproducer goods are "merely incidental" to the total sales of producer goods. Thus, if the sales of nonproducer goods are so substantial that they cannot be considered as merely incidental, the question of whether the nonproducer sales are a "necessary supplement" to the effective marketing of producer goods is immaterial because the cooperative has violated the Code provisions governing its exempt status. Rev. Proc. 67-37, 1967-2 Cum. Bull. 668. This exception is applicable to the retail marketing of nonproducer goods by Bridgeman Division.

Land O'Lakes argues that Bridgeman's marketing of nonproducer goods at retail was incidental to the marketing of producer goods at retail and was for the purpose of selling the producer goods more advantageously. In an attempt to prove its sales of nonproducer goods were incidental to its sales of producer goods, Land O'Lakes proposes three standards of measurement: (1) total sales of nonproducer goods at wholesale and retail measured against total sales at wholesale and retail, (2) total sales of nonproducer "soft" goods (non-dairy items marketed by Bridgeman) measured against total sales of soft goods (dairy and non-dairy items marketed by Bridge-

man Division and Land O'Lakes Fluid Milk and Ice Cream Division), or (3) total sales of nonproducer soft goods measured against total sales of soft goods by Bridgeman only. Regardless of the standard of measurement employed, plaintiff asserts that it is unimportant upon which basis the percentage of nonproducer goods is computed because the important question is whether or not the nonproducer goods were marketed for the purpose of more advantageusly selling the producer goods.

Land O'Lakes further argues that nonproducer goods were introduced in an attempt to turn losses incurred by Bridgeman into profits by attracting more customers who would purchase more producer goods. It is concluded that the availability of the nonproducer goods in 1963 did effect a substantial profit on the sale of producer items even though Bridgeman incurred a loss on the sale of nonproducer items. Given this motivation, Land O'Lakes states that the incidental marketing of nonproducer goods by Bridgeman and resulting profits made on the marketing of producer goods support its argument that the purpose of this activity was to enhance the sales of producer items and was not in violation of §521(b)(1)(A).

The government argues that the marketing of nonproducer goods at retail was not incidental and was not proven by plaintiff to be necessary. In reliance on the Revenue Procedure explained above, the government states that the standard of measurement employed to determine the percentage of nonproducer goods marketed by Bridgeman should be the total retail sales of nonproducer goods measured against the total retail sales of the marketing activity. Applying this standard to Bridgeman's marketing activity, the government computes that Land O'Lakes' total retail sales of nonproducer goods in 1963 were seventeen percent of the total retail sales of the

marketing activity. Therefore, the government reasons, assuming that the nonproducer retail sales were "necessary" in accordance with the guidelines of the Revenue Procedure, the percentage of such sales was too substantial to be considered "merely incidental" in light of the five percent limitation imposed by the Revenue Procedure. In the alternative, the government asserts that even if the sales of nonproducer goods at retail were found by the Court to be incidental, plaintiff failed to prove that such sales were necessary to the effective marketing of producer goods.

The issue of whether or not a farmers' cooperative exempt from tax under §521 may market nonproducer goods at retail has not been decided by any court. However, the 1967 Revenue Procedure relied upon by the government does provide guidelines under which a farmers' cooperative may market nonproducer goods at retail to a limited extent. The Revenue Procedure also provides that "where sales of nonproducer sideline items exceed five percent, a determination whether the sales constitute a necessary supplement to the efficient marketing of producer items will be made *on the basis of all the facts and circumstances in the particular case.*" Rev. Proc. 67-37, *supra* (emphasis added).

On the facts here, I find that the retail marketing of nonproducer goods by Land O'Lakes during 1963 was incidental to the effective marketing of producer goods and did not violate §521(b)(1)(A) of the Code. Whether the introduction and marketing of nonproducer goods resulted in a profit in and of itself is not the determinative factor. The sum of the evidence offered by both parties was not indicative of a *separate* profit motive on the part of Land O'Lakes. On the contrary, the evidence was that the introduction of nonproducer goods by Bridgeman was for the purpose of attracting more retail customers in order to sell more producer goods.

Furthermore, the volume of nonproducer goods marketed was incidental to the total volume of retail goods marketed. The Court does not arrive at this conclusion solely by the computation of the percentage of nonproducer goods marketed at retail measured against total retail goods marketed but rather by determining the *purpose* for which the non-exempt activity was conducted, *i.e.*, to enhance the sales of producer goods. *See Eugene Fruit Growers Ass'n v. Commissioner of Internal Revenue*, 37 B.T.A. 993, 1001 (1938). This purpose is in harmony with the apparent intent of the Congress in granting tax exemption to farmers' cooperatives. Although an excessive percentage of non-exempt activity in any given year may cause a farmers' cooperative to forfeit its exempt status, the facts here support the conclusion that plaintiff's retail marketing of nonproducer goods in 1963 was incidental to the main purpose of selling producer goods more advantageously.

The second sub-issue is whether Land O'Lakes violated §521(b)(1)(A) by the marketing of nonproducer goods at wholesale. As explained above, Northwest, Land O'Lakes' wholly-owned subsidiary, purchased nonproducer goods from proprietary companies and resold the goods to plaintiff at cost pursuant to a written contract. Land O'Lakes would then market the nonproducer goods at wholesale and distribute the earnings to the subsidiary in accordance with the contract. The subsidiary was obligated to return the earnings to Land O'Lakes which in turn redistributed them to its members and other producers in the subsequent year.

The Code and the Treasury Regulations do not specifically authorize the marketing of nonproducer goods by exempt farmers' cooperatives. Nevertheless, the I.R.S. has recognized two limited exceptions to this congressional and administrative silence as noted above, *i.e.*, the marketing of nonproducer

goods in certain emergency situations (Rev. Rul. 69-222, *supra*) and the marketing of nonproducer goods at retail within certain guidelines (Rev. Proc. 67-37, *supra*); however, the recognition by the I.R.S. of limited retail marketing of nonproducer goods has not been extended to the marketing of nonproducer goods at wholesale.

Land O'Lakes argues that the wholesale marketing of nonproducer goods purchased from Northwest was incidental in relation to the total volume of goods marketed and was necessary for the purpose of more advantageously selling producer goods. Specifically, plaintiff states that the nonproducer goods procured by the subsidiary and resold to the parent were the same products as those marketed for the members and other producers and that any profit derived from this activity was properly redistributed to the cooperative's members and other producers. It is argued that the cooperative could have purchased the nonproducer goods directly from the proprietary companies, *i.e.*, avoiding the use of Northwest as a middleman, and distributed the profits to members and other producers without violating §521(b)(1)(A). Land O'Lakes asserts that it was required under its Articles of Incorporation and By-laws to distribute profits derived from the purchase of products to each individual or entity from which it purchased the products. Thus, it is reasoned that the use of Northwest was simply a method employed in order to comply with this provision of the Articles and By-Laws and still be able to distribute the profits to the members and other producers rather than to the proprietary companies with which it was dealing. Since the marketing of wholesale nonproducer goods was allegedly consistent with the intent of §521(b)(1)(A), Land O'Lakes contends that the use of the

subsidiary to satisfy a provision of the cooperative's Articles and By-Laws does not alter the legality of the sales.

The government argues that the wholesale marketing of nonproducer goods by cooperatives is not specifically provided for by the Code or Regulations. Furthermore, the I.R.S. has not set forth any exception which authorizes the marketing of an incidental amount of nonproducer goods at wholesale as it has in the case of nonproducer goods marketed at retail. The government reasons that while it may be necessary for a cooperative to market a limited amount of nonproducer goods at retail in order to attract the individual customer to buy producer goods, the same rationale is not applicable to the wholesale marketing of nonproducer goods because the typical wholesale customer (*e.g.*, a large grocery store chain) could purchase nonproducer goods from another supplier and still continue to buy producer goods at wholesale from the cooperative. Therefore, it is urged the standard applied to the wholesale marketing of nonproducer goods should be considerably more strict than the standard applied to the retail marketing of nonproducer goods. The government concludes that plaintiff has not established that the marketing of nonproducer goods at wholesale was necessary to the effective marketing of producer goods at wholesale.

Although there is no statutory, judicial, or administrative position specifically authorizing the wholesale marketing of nonproducer goods by a farmers' cooperative, the Court finds that the evidence offered by Land O'Lakes with regard to the purchases from its subsidiary establishes that the activity was in accord with the apparent congressional intent which underlies §521(b)(1)(A). We are not persuaded that the distinction between a cooperative's wholesale and retail marketing activities is properly characterized by the government.

In 1963 plaintiff's wholesale marketing of nonproducer goods was approximately 3.4 percent of the total marketing of wholesale goods. Nonproducer goods were obtained through the subsidiary for two purposes: (1) for use by a cheese packaging plant owned by Land O'Lakes during a transition period in which there were not enough producer goods available to operate the plant efficiently; (2) for use in Land O'Lakes' branches to provide a full line of products for purchase by the wholesale customer. The percentage of nonproducer goods purchased through the subsidiary for use by the cheese packaging plant during the transition period declined significantly as Land O'Lakes was able to procure producer goods from members and other producers. The temporary use of nonproducer goods was incidental to the main purpose of the cooperative, *i.e.*, to promote the marketing of producer goods, and was for the purpose of aiding Land O'Lakes' exempt activity. *See, e.g.*, *Commissioner of Internal Revenue v. Chicago Graphic Arts Federation*, 128 F.2d 424 (7th Cir. 1942) (business league exempt when non-exempt activity was temporary and for purpose of aiding exempt activity). Similarly, the nonproducer goods purchased through Northwest for use in the branches were incidental to the main purpose of the cooperative. These nonproducer goods were marketed to provide a full line of products for the wholesale customer (*e.g.*, grocery chains and restaurants) so that the cooperative could more advantageously sell the producer goods. Therefore, the Court finds that the wholesale marketing of nonproducer goods purchased through Northwest was incidental and subordinate to the total wholesale marketing activity of plaintiff during 1963 and was in furtherance of the cooperative's main purpose of enhancing the marketing of producer goods. This finding comports with the apparent intent of Congress in enacting §521(b)(1)(A).

The third sub-issue is whether Land O'Lakes violated §521(b)(4) by purchasing supplies for nonmember nonproducers in excess of fifteen percent of the value of all its purchases in 1963 and/or violated §§521(b)(1)(B), 1382, or 1388 by the payment of patronage dividends to the producer-customers of the agent-buyers rather than to the agent-buyers themselves. Section 521(b)(4) provides in part that "[e]xemption shall not be denied any such association [farmers' cooperative] . . . which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases." The issue is whether the agent-buyers were agents of the producer-customers or independent entrepeneurs. If the agent-buyers are found to be agents of the producer-customers, then Land O'Lakes did not violate §521(b)(4) by purchasing supplies for nonmember nonproducers in excess of fifteen percent of the value of all its purchases for 1963. Conversely, if the agent-buyers are found to be independent entrepeneurs, then Land O'Lakes' total supply activities for nonmember nonproducers exceeded the fifteen percent limitation.

Section 521(b)(1)(B) provides that "farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis . . . (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses." Sections 1382 and 1388 were enacted as part of the Internal Revenue Act of 1962. Although a farmers' cooperative must comply

with requirements of §521 to be exempt from tax, an exempt or nonexempt cooperative may nevertheless be subject to taxation if it does not comply with requirements of §§1382 and 1388. Also, the requirements of §§1382 and 1388 may affect the statutory construction of the exemption requirements of §521. As it relates to patronage, §521 requires that a cooperative distribute patronage dividends (net margins) equally between member-patrons and nonmember-patrons. Sections 1382 and 1388 provide additional guidelines governing the method of distributing patronage dividends. Section 1382(b) authorizes both exempt and non-exempt cooperatives to deduct patronage dividends if distributed in the manner prescribed. Section 1382(c) authorizes only exempt cooperatives to deduct non-patronage distributions if distributed in the manner prescribed. Section 1388(a) defines the term "patronage dividend" for purposes of the deduction. *See generally* Clark & Warlich, *Taxation of Cooperatives: A Problem Solved?* 47 Minn. L. Rev. 997 (1963). Thus, if the Court finds that Land O'Lakes did not violate the fifteen percent limitation on purchases for nonmember nonproducers, it must further determine whether the payment of patronage dividends to the producer-customers rather than to the agent-buyer was in violation of §§521, 1382 or 1388. Finally, even if the payment of patronage dividends to the producer-customers is found to be proper, the Court must decide whether the products were supplied to the producer-customers "at actual cost, plus necessary expenses" under §521(b)(1)(B).

Land O'Lakes explains that under a written agreement between the agent-buyer and the cooperative supplies were sold to the agent-buyer at wholesale in the same manner as supplies sold to an independent dealer. The agent-buyer would then sell the supplies to the producer-customers at the same compe-

titive retail price as used by the independent dealer. However, unlike the arrangement with an independent dealer, the agreement required that the agent-buyer forego his right to receive the patronage dividends as a result of dealing with Land O'Lakes on a cooperative basis and allow such dividends to be passed on to the producer-customers.

Plaintiff cites various sections of the *Restatement of Agency* in an attempt to support its argument that the agent-buyer was acting as an agent for the producer-customers in accordance with the agreement. It is argued that the agent-buyer is the agent of the producer-customers because he has agreed to act "primarily for the benefit" of the producer-customers and not for his own benefit. Restatement (Second) of Agency §14K (1957). Land O'Lakes contends that the "primary benefit" is the patronage dividend which the agent-buyer is obligated under the agreement to pass on to the producer-customers. There is no principal at the time the agent-buyer purchases the supplies from the cooperative on behalf of the producer-customers, but Land O'Lakes submits that the agency relationship is ratified at the time the agent-buyer furnishes the cooperative with the receipts of the sales signed by the principals (producer-customers). *See* Restatement (Second) of Agency §85 (1957). Therefore, since the supplies purchased by the agency-buyers were not made for "persons who were neither members nor producers," plaintiff asserts that it did not violate §521(b)(4) by exceeding the fifteen percent limitation.

With regard to the payment of patronage dividends, Land O'Lakes states that "the government takes the position that plaintiff's distribution" of the patronage dividends to the members and other producers "would not, standing alone, be cause for losing its exemption" under any of the three sub-

issues discussed above. Post-Trial Brief for Plaintiff at 2. Land O'Lakes further states that "[a]ccording to our understanding of the government's position, there is no issue as to patronage under Section 521(b) but there is an issue of patronage under Sections 1382 and 1388" of the Code. Post-Trial Brief for Plaintiff at 12. However, as noted below, the government does allege that the payment of patronage dividends to the producer-customers of the agent-buyers was in violation of §521(b)(1)(B) and therefore deprived the cooperative of its exempt status. *See* Post-Trial Brief for Defendant at 44-46.

Assuming the agent-buyer is the agent of the producer customers, plaintiff contends that the distribution of patronage dividends to the producer-customer, in compliance with the contractual obligations between the cooperative and the agent-buyer, was proper in light of the guidelines of §§1382 and 1388 governing the method of patronage dividend distribution. Treasury Regulation §1.1388-1(e) defines a "patron" as "any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association . . ." Since both parties agree that the distribution of patronage dividends complied with the other requirements of §§1382 and 1388, Land O'Lakes argues that the producer-customer was the true patron within the definition of Treasury Regulation 1.1388-1(e) and that the transactions which included supplies purchased by the agent-buyers from plaintiff and sold to the producer-customer constituted "business done . . . for such patron," *i.e.*, the producer-customer. Therefore, it is argued that Land O'Lakes' payment of patronage dividends under the agent-buyer agreement did not violate §§1382 and 1388 and was consistent with the exemption requirement of §521.

In addition, plaintiff asserts that the products obtained by the agent-buyers from the cooperative were sold to the producer-customers "at actual cost, plus necessary expenses." The cooperative reasons that on the basis of evidence submitted the cost to the producer-customers who purchased products from the company stores was the same as the cost to the producer-customers who purchased products from the agent-buyer. Moreover, any profit made by the agent-buyer could justifiably be categorized as a "necessary expense" due to the fact that the agent-buyers were located in convenient places to supplement the lack of company stores. Thus, Land O'Lakes concludes that the expenses to the producer-customers were in compliance with the requirement of §521(b)(1)(B) that the supplies be furnished "at actual cost, plus necessary expenses."

The government maintains, on the other hand, that the agent-buyer was an independent entrepeneur acting on his own behalf and not as agent for the producer-customer. It asserts that the agency rationale proposed by Land O'Lakes was merely a system devised by the cooperative to avoid the fifteen percent limitation imposed by §521(b)(4). Therefore, the government claims plaintiff violated its tax exempt status and should be held to lose its exemption.

In addition, it is contended that even if Land O'Lakes did not exceed the fifteen percent limitation, the cooperative was still in violation of §521 because it distributed patronage dividends to the producer-customer based on the proceeds of sales to the agent-buyer rather than the proceeds of sales to the producer-customers. Since §521 contemplates the computation of the proceeds based on sales to the agent-buyer, the government reasons that the agent-buyer is the patron and that any distribution of patronage dividends to other persons, *e.g.*, producer-customers, was in violation of the statute.

Moreover, the government states that even if the producer-customers were found to be the patrons, plaintiff still violated §521(b)(4) because the supplies were not purchased by the producer-customers "at actual cost, plus necessary expenses." The government reasons that any profit made by the agent-buyer raised the purchase price paid by the producer-customer and that the purchases by the producer-customer were in excess of "actual cost, plus necessary expenses."

Whether an exempt farmers' cooperative's use of an agent-buyer to sell supplies to producer-customers violates the fifteen percent limitation under §521(b)(4) concerning purchases from nonmember nonproducers has not been judicially decided. Plaintiff's reliance on agency principles to support its argument that the agent-buyer was acting in a fiduciary capacity on behalf of the producer-customers appears to be a strained legal position, but the Court believes the contract between Land O'Lakes and the agent-buyers was a permissible arrangement and not violative of the statute. The evidence established that the use of the agent-buyer was necessitated by a lack of other facilities to adequately provide for the supply needs of the producer-customers. The government has not made any showing that the agent-buyers breached the contract or acted in any manner contrary to the intended purpose of the arrangement to supplement the lack of supply outlets for the benefit of the producer-customers. The Court concludes that the purchases made for "persons who are neither members nor producers" did not exceed fifteen percent of the value of all Land O'Lakes purchases for the calendar year 1963 and that the use of the agent-buyer was permissible.

To determine whether or not the payment of patronage dividends to the producer-customers complied with the Code, the Court must construe the exemption requirements of §521 in light of the statutory language found in §§1382 and 1388. This

construction depends upon the definitions of the terms "patron" and "patronage dividend," A patron is a person "with whom or *for whom*" a cooperative does business on a cooperative basis. Treas. Reg. §1.1388-1(e) (emphasis added). The Court finds that the producers-customers who purchased supplies from the agent-buyers were the true patrons "for whom" the cooperative was conducting business on a cooperative basis. A patronage dividend is "an amount paid to a patron . . . on the basis of quantity or value of business done with or *for* such patron." Int. Rev. Code of 1954, §1388(a)(1) (emphasis added). The Court finds that the amounts paid to the producer-customers were patronage dividends based on "business done . . . *for* such patron." Since the distributions of net margins to the producer-customers was in accord with the definitions of "patron" and "patronage dividend" as set forth by the Code and Treasury Regulations, the Court concludes that Land O'Lakes did not violate the exemption requirement of §521 and thus, for purposes of this issue, was operating as an exempt farmers' cooperative in 1963.

The Court also finds that the supplies purchased by the producer-customers were sold "at actual cost, plus necessary expenses" in compliance with §521(b)(1)(B) because any profits accruing to the agent-buyers on the sales of supplies to producer-customers properly may be termed "necessary expenses" within the meaning of that statutory phrase. The evidence supports the conclusion that the cost to the producer-customers would be about the same whether made from the agent-buyers or the company stores. Thus, Land O'Lakes was operating within the requirement of §521(b)(1)(B) which requires such purchases to be "at actual cost, plus necessary expenses."

In summary, the Court finds that the marketing and supply activities of Land O'Lakes for the calendar year 1963 were

not in violation of §521 of the Code and that plaintiff was therefore properly operating as a tax exempt farmers' cooperative during that year. Although the Court has found that Land O'Lakes complied with the exemption requirements of §521, there still remains a secondary issue in dispute which relates to the deductibility of the dividends distributed by Land O'Lakes to Northwest.

The secondary issue is whether dividends paid by Land O'Lakes to Northwest based on earnings derived from the subsidiary's purchases of nonproducer goods are deductible under §§1382 and 1388. Plaintiff argues that the subsidiary was a separate corporate entity and should be considered the patron of the cooperative for purposes of §§1382 and 1388. In response, the government argues that the subsidiary was a sham and that under §1382(b)(1) a cooperative may not distribute alleged patronage dividends to itself and then deduct that amount from its taxes. The Court finds that the subsidiary was a separate corporate entity and was the patron for purposes of §§1382 and 1388. The evidence establishes that the subsidiary did conduct a minimal amount of business in purchasing nonproducer goods from proprietary companies. As long as the purpose of the subsidiary was in harmony with the intent of Congress, *i.e.*, to provide a better wholesale marketing activity for producer goods, and was not "conducted on an ordinary profit-making basis," the creation of the subsidiary and subsequent distribution of patronage dividends to it, under an agreement to return such dividends to Land O'Lakes which redistributed them to the members and other producers, was not violative of §§1382 and 1388. *See* S. Rep. No. 52, 69th Cong., 1st Sess. 23-24 (1926).

The issues here presented and decided have not previously been decided by any court and little guidance is available in

the reports accompanying the legislation as to the specific intent of the Congress as to these issues. The commentators have expressed themselves on whether a farmers' cooperative should be exempt from taxation. *Compare, e.g.*, Caplin, *Taxing the Net Margins of Cooperatives*, 58 Geo. L.J. 6 (1969) *with* Zivan, *Need for Reform in Taxation of Agricultural Cooperatives?*, 5 Ga. L. Rev. 529 (1971). Our Eighth Circuit Court of Appeals has recognized that the congressional purpose in bestowing tax exempt status on farmers' cooperatives was based upon the policy that a strong and prosperous agriculture is necessary for the national welfare. *Cooperative Grain and Supply Co. v. Comm. of Internal Revenue*, 407 F.2d 1158, 1162-63 (8th Cir. 1969).

We are satisfied that Land O'Lakes was proceeding in complete good faith in each of the contested areas of its operations. Its conduct was above board and satisfied the basic requirement of a cooperative, that it operate for the sole benefit of its members. There was no private profit or private profit motive. The nonexempt activity in which it participated was incidental to, and in furtherance of, its exempt activity, and in my view, proper under its exemption.

I conclude that the Director of Internal Revenue was in error when he terminated plaintiff's tax exemption for the year 1963.

Plaintiff is directed to submit Proposed Findings of Fact, Conclusions of Law and Order for Judgment reflective of these expressions and the parties are directed to prepare a computation of the tax refund due in accordance with their stipulation.

Dated: September 11, 1973.

EDWARD J. DEVITT
Chief Judge
United States District Court

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 74-1100

LAND O'LAKES, INC., formerly
LAND O'LAKES CREAMERIES, INC.,
a Minnesota corporation,
Plaintiff-Appellee,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court
for the District of Minnesota.

Submitted: September 12, 1974.
Filed: April 30, 1975.

Before GIBSON, Chief Judge; BRIGHT, Circuit Judge,
and TALBOT SMITH, Senior District Judge.*

BRIGHT, Circuit Judge.

In this action, Land O'Lakes, a cooperative corporation, seeks a refund of income taxes in the sum of $254,978.74 (including interest) which it paid under a deficiency assessment for the year 1963. This deficiency arose because the Govern-

* TALBOT SMITH, Senior District Judge, Eastern District of Michigan, sitting by designation.

ment revoked Land O'Lakes' status as an exempt farmers' cooperative under §521 of the Internal Revenue Code, 26 U.S.C. §521 (1970) for its operations during calendar year 1963. The district court ruled in taxpayer's favor and granted the refund. *Land O'Lakes, Inc. v. United States*, 362 F. Supp. 1253 (D. Minn. 1973). The Government brings this appeal. We reverse.

The taxpayer operates essentially as a federated cooperative (a cooperative whose members are other cooperatives) but it does have individual members. Taxpayer primarily markets its members' products (milk products, such as butter, milk powder, cheese, and fluid milk, as well as eggs, chickens, and turkeys) through wholesale and retail sales. It also performs a purchasing function for its members and patrons by buying and processing feed, fertilizer and seed and wholesaling them to member cooperative stores and other outlets for sale to farmers.[1] The taxpayer engaged in a multi-million dollar business, grossing about $200,000,000 in marketing operations and expending approximately $30,000,000 to purchase supplies for its members and other patrons in 1963.

Taxpayer engaged in retail marketing through operation of 20 outlets (some of which were small restaurants) known as Bridgeman's. The Bridgeman Division sold dairy products, such as milk and ice cream, obtained from members of the cooperative and from other producers, and it also sold sideline items, such as hamburgers, frozen foods, soup, and fried potatoes.

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[1] The regulations of the Internal Revenue Service provide that an association engaged both in marketing farm products and purchasing supplies and equipment may operate as an exempt cooperative only if it meets the requirements of the Code as to each of its functions. 26 C.F.R. §1.521-1(c) (1963).

The rules applicable to exempt farmers' cooperatives appear in §521(b) of the Internal Revenue Code, 26 U.S.C. §521(b). They require that such an organization operate on a *cooperative basis* for the purpose of marketing the products of *members* or other *producers* and turning back to them the proceeds of sales, less the necessary marketing expenses, or operate on a cooperative basis for the purpose of *purchasing supplies and equipment* for the use of members or other persons and turning over such supplies and equipment at actual cost plus necessary expenses.[2] The Code limits exempt farmers' cooperatives' transaction of business with nonmembers and nonproducers. *See* 26 U.S.C. §521(b)(4). As relevant here, a supply cooperative does not qualify for an exemption when it purchases supplies for persons who are neither members nor producers to the extent of more than 15 percent of the value of all its purchases. *Id.*[3]

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[2] Subsection (b)(1) of §521 reads as follows:

(b) Applicable rules.

(1) Exempt farmers' cooperatives. The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) [26 U.S.C. §521(a)] are farmers' fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

[3] Subsection (b)(4) of §521 reads as follows:

(4) Transactions with nonmembers. Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

Only some of Land O'Lakes' total marketing and supply activities are under review in the instant case. First, the taxpayer, as part of its supply activities in 1963, made sales at wholesale to a number of agricultural supply stores. These stores were not member cooperatives of the taxpayer. The stores in turn sold the supplies or equipment at retail to their customers. The sales by taxpayer to these retail stores were made under an agreement which designated the retailer as an agent for the ultimate farmer-consumer and stipulated that the farmer-consumer would receive any patronage dividends attributable to the transactions.

Second, as part of its marketing activities, the taxpayer marketed at wholesale in 1963 certain products, such as special cheeses and brown eggs, which it obtained from nonmembers because they were not available from its member cooperatives. Taxpayer's wholly-owned affiliate, Northwest Dairy Products Company, made contracts for these items with a number of proprietary companies and received patronage dividends, as allocated by taxpayer, for marketing them. Ultimately, these dividends were reallocated to taxpayer's members and producers who marketed their products through Land O'Lakes.

Third, as we have noted, taxpayer sold at retail nonproducer items such as hamburgers, frozen foods, and soft drinks through its Bridgeman ice cream stores. These sales amounted to $977,475 in 1963, which the Government calculates as 17 percent of Land O'Lakes' marketing sales at retail that year.

In 1970, the Government declared that taxpayer had forfeited, beginning in 1963, its entitlement to be taxed as an exempt farmers' cooperative under §521 because of these marketing and supply activities.

The primary issue before us is whether taxpayer violated §521(b) of the Internal Revenue Code and thus lost its exemption on any of several grounds urged by the Government.[4] We hold that taxpayer exceeded the scope of permissible transactions for a tax exempt cooperative in both its marketing and supply activities and we uphold the Government's denial of the exemption. We deem it necessary to discuss only the first three of the five grounds for reversal advanced by the Government. *See* note 4 *supra*.

Preliminarily, we note that both exempt and nonexempt farmers' cooperatives receive special tax treatment under the Internal Revenue Code. Such organizations can deduct from gross income amounts allocated and distributed to patrons out of the net earnings of the cooperative. Subchapter T of the Internal Revenue Act of 1954, as amended, 26 U.S.C. §§1381-1388. *See generally* Logan, *Federal Income Taxation of Farm-*

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[4] The Government divides its contentions that taxpayer could not claim exempt status into separate and alternative subdivisions as follows:

1) The taxpayer's purchase of supplies and equipment which it distributed and sold through nonmember retail outlets, referred to as agent-buyers, constituted purchases for the use of nonmembers-nonproducers. These purchases, when added to other purchases which were sold outright to nonmembers-nonproducers, exceeded the 15 percent limitation of §521(b)(4).
2) In the alternative, if the transactions with agent buyers did not violate §521(b)(4), they nevertheless fall outside those authorized for an exempt cooperative because, inasmuch as the retailers made a profit on each transaction, the supplies did not reach the ultimate consumer at actual cost less necessary marketing expenses as required by §521(b)(1).
3) If the agent-buyer transactions do not suffice to bar taxpayer from claiming an exempt status, Land O'Lakes nevertheless lost its exemption by paying patronage dividends to Northwest, a nonproducer.
4) Alternatively, on the marketing side, the taxpayer violated §521(b)(1) by selling nonproducer merchandise (certain kinds of butter, jumbo and brown eggs, fresh poultry, turkeys, milk powder, cheese speciaities) at wholesale.
5) Alternatively, on the marketing side, the volume of sideline sales of nonproducer products at retail (hamburgers, soft drinks, etc.) exceeded the five percent permissible deviation adopted by the Internal Revenue Service for the sale of nonproducer products by an exempt cooperative.

ers' and Other Cooperatives: Part II, 44 Tex. L.Rev. 1269 (1966). A farmers' cooperative qualifying as *exempt* obtains additional tax advantages, for it may also deduct from gross income (1) amounts paid during the taxable year as dividends on its capital stock and (2) amounts paid or properly allocated to its patrons from earnings derived from business done with the United States or its agencies, or from sources other than patronage (such as earnings on its investments). 26 U.S.C. §1382(c). *See generally* Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 Tex. L.Rev. 250, 279-85 (1965). In seeking retention of its exempt status, Land O'Lakes desires the benefit of all deductions from gross income authorized by law for an exempt cooperative. We turn to a consideration of whether its conduct in 1963 justified the Government's determination that it had lost its exempt status.

I. *Agent-Buyer.*

A. Prior to 1963, taxpayer distributed supplies and equipment to its members and other farmers through its member cooperatives, which at that time were exclusively creameries, and through company-owned stores. In the years immediately preceding 1963 the number of member cooperatives began to dwindle as small creameries either went out of business or were acquired by larger concerns. Taxpayer found that it was unable to compensate for this reduction in its distribution capacity by establishing company stores and by sales to cooperative grain elevators. To restore this capacity it formulated the device of the agent-buyer.

Agent-buyers were "primarily small businesses with a single owner-operator." [Order of district court, Dec. 4, 1973, Civ. No. 3-71-49, at 15.] They ranged in size from those with modest inventories to those with "a sizeable business." [Trial Tr. 117-18.] In addition to acting as agent-buyers of taxpayer, these businesses ordinarily were established feed and agricultural supply dealers. Whatever their motive in agreeing to act as agent-buyers, the dealers contracted with taxpayer, at taxpayer's initiative, to sell taxpayer's supplies to farmers. The terms of the agreement between these dealers and appellee are important and bear summarization:

1) Taxpayer agreed to deliver Land O'Lakes feed, seed, and fertilizer, as ordered by agent-buyer, on regularly established credit terms.
2) The agent-buyer agreed to sell these items to farmers by means of sales slips furnished by Land O'Lakes, with copies of the slips to be returned to Land O'Lakes.
3) Land O'Lakes agreed to calculate patronage dividends on the basis of sales slips returned by the agent-buyer and the agent-buyer agreed that such dividends belonged to the retail farmer-customers of the agent-buyer.
4) Feeds used as an ingredient in the agent-buyer's own feed mixture were not covered by the agreement. As to these feeds, the agent-buyer was deemed the patron and, as such, entitled to patronage dividends. [App. 100-01.]

Notwithstanding the taxpayer's intent to create a cooperative-patron arrangement with the farmer-consumer, the record establishes that Land O'Lakes sold its supplies unconditionally to the retail outlets without knowing the identity of the persons who would receive the products as alleged "principals." The risk of loss or sale remained with the retailers on delivery. The agent-buyer remained free to set the retail price on his sale to a customer and would gain the profit or bear any loss incident to the sale. Except for their obligation to forward sales slips to the taxpayer, agent-buyers, who operated farm stores and sold primarily to farmers, marketed

Land O'Lakes' products just as they did any other inventory item.

The district court did not find any agency relationship between the agent-buyer and the ultimate farmer-consumer at the time that Land O'Lakes delivered its feed or other products to the agent-buyer. The court held that because these supplies ultimately reached the farmer, who thereby became entitled to the patronage dividend, their purchase by Land O'Lakes for sale to agent-buyers should not be considered a purchase made by Land O'Lakes for person who were "neither members nor producers" within the 15 percent limitation of §521(b)(4). That limitation reads as follows:

> (4) Transactions with nonmembers. Exemption shall not be denied any such association * * * which purchases supplies and equipment for *nonmembers* in an amount the value of which does not exceed the value of the supplies and equipment purchased for *members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.* [Emphasis added.] [5]

We disagree with this construction of the statute as applied to the undisputed facts disclosed here. Statutory language exempting farmers' cooperatives from the full burdens of taxation is to be strictly construed. *Cooperative Grain & Supply Co. v. Commissioner*, 407 F.2d 1158, 1162 (8th Cir. 1969); *see Farmers Union Co-op Co. v. Commissioner*, 90 F.2d 488, 493 (8th Cir. 1937). Persuasive policy reasons support this construction. Congress provided tax-exempt status for agricultural cooperatives satisfying certain carefully defined cri-

[5] *See* note 3 *supra*, for the full text of this subsection.

teria in order to enable the farmer-members of such cooperatives better to compete in the marketplace. Congress made the determination that agricultural cooperatives which could not comply with these criteria did not need the competitive advantages conferred by tax exemption. *See generally* Paul, *Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes*, 29 Minn. L.Rev. 343 (1945).

Tax liability, or exemption therefrom, depends upon the substance and not the form or name of a transaction or event. *E.g., Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260, 266-67 (1958); *Dingman v. United States*, 429 F.2d 70, 73 (8th Cir. 1970); *Oesterreich v. Commissioner*, 226 F.2d 798, 801-03 (9th Cir. 1955). Here, taxpayer elected to wholesale its supplies to nonmember proprietary stores which resold these items at retail. [Land O'Lakes parted with title to these goods without knowing who, if anyone, the agent-buyer's "principal" would be and without attempting to assure the agent-buyer's sale of the goods to "principals" only] The agent-buyer device must be disregarded as a legal fiction. *See Commissioner v. P. G. Lake, Inc., supra*, 356 U.S. at 266-67.[6]

The supplies which Land O'Lakes purchased for sale to independent retail farm stores must be deemed supplies purchased for persons who were neither members nor producers. Inasmuch as the parties agree that by including these items in the value of other supplies sold by Land O'Lakes to nonmembers and nonproducers the 15 percent limitation of §521

[6] This illusory agency must be distinguished from the true agency relationship at issue in *Producers Gin Ass'n v. Commissioner*, 33 T.C. 608 (1959), a case cited and mistakeny relied upon by the appellee.

(b)(4) is exceeded, the Government properly denied Land O'Lakes exempt status for 1963.[7]

B. Additionally, Land O'Lakes' argument that it actually intended by use of the agent-buyer device to transact business with the farmer as its cooperative patron completely loses its force when the transaction is analyzed under basic principles applicable to an exempt supply cooperative. Under these principles, a cooperative must turn over supplies and equipment to members or other persons at "actual cost, plus necessary expenses." 26 U.S.C. §521(b)(1)(B). Here, the ultimate consumer, the farmer, paid the retailer, the agent-buyer, a price which likely included a markup on cost to return a profit to the retailer. Such an arrangement offends the statutory requirement that an exempt farmers' supply cooperative operate on a nonprofit basis. [Here, a middleman retailer entered into the chain of distribution to reap a profit from the transaction. Such a profit should be distinguished from a permissible "necessary expense" under §521(b)(1)(B).] Taxpayer, by its failure to comply with that section of the Code, lost its exempt status for the year 1963.

II. *Northwest Dairy Products Company.*

We also hold that taxpayer breached the rules for retaining its exemption by treating its subsidiary, Northwest, as a patron and paying it patronage dividends on the margins earned from marketing certain products.

Northwest purchased the products in question from outside firms on a contract basis and Land O'Lakes thereafter marketed them. The taxpayer purchased at cost some $5,600,000 worth of these products from Northwest in 1963. The products

[7] We note that in later years the taxpayer found the restrictions of §521 unduly burdensome to its business operations. In 1970 the taxpayer elected to begin operation as a nonexempt cooperative. [Trial Tr. 27.]

consisted of items that Land O'Lakes' members or producers could not supply, such as brown eggs, certain kinds of butter, special kinds of poultry, turkeys, milk powder and cheese, and raw, bulk cheese for use in taxpayer's newly-acquired cheese processing plant in Spencer, Wisconsin.

Departing from what was presumably its practice prior to 1963, Land O'Lakes chose not to treat as patrons and return to them any patronage dividends the various proprietary companies from which Northwest purchased these products. Rather, the profits attributable to Land O'Lakes' distribution of the products were returned to Northwest as patronage dividends. Following receipt of a dividend, which in 1963 amounted to $63,734.76, Northwest refunded it to the taxpayer and taxpayer would then, in the next fiscal year, channel the dividend to its other producer-patrons. [Order of district court, Dec. 4, 1973, at 10-11.]

The terms of 26 U.S.C. §521(b)(1)(A) expressly require that a cooperative market only the products of "members or other producers." Land O'Lakes' practice of marketing products obtained from Northwest violates this requirement, for Northwest is not a producer but rather a purchasing agent for Land O'Lakes and Northwest, even as a member, did not market its own produce, but that of others. Although the term producers is not specifically defined by law, a regulation of the Internal Revenue Service impliedly excludes Northwest from its coverage by referring to "farmers, fruit growers, dairymen, etc." as producers. 26 C.F.R. §1.521-1(a) (1).[8]

[8] In *Cooperative Grain & Supply Co. v. Commissioner*, 407 F.2d 1158 (8th Cir. 1969), this court referred to farmers, fruit growers, livestock growers, and dairymen as producers. *Id.* at 1159.

In ruling that these transactions with Northwest did not justify revocation of taxpayer's exempt status, the district court made the following statement:

> Although there is no statutory, judicial or administrative position specifically authorizing the wholesale marketing of nonproducer goods by a farmers' cooperative, the court finds that the evidence offered by Land O'Lakes with regard to the purchases from its subsidiary establishes that the activity was in accord with the apparent congressional intent which underlies §521(b)(1)(A). [362 F. Supp. at 1258.]

We do not believe such a practice by an exempt cooperative can be justified on the basis of any "underlying" Congressional intent, for the statute very specifically limits exemption to an operation restricted in scope to that of "farmers', fruit growers', or like associations organized and operated on a cooperative basis * * * for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses * * *." 26 U.S.C. §521(b)(1). Where statutory language is unambiguous, as this is, we have no occasion to consider Congress' intent except as it is expressed in the statute itself. *E.g.*, *Taft v. Commissioner*, 304 U.S. 351, 358-59 (1938); *Birmingham v. Rucker's Imperial Breeding Farm, Inc.*, 152 F.2d 837, 840-41 (8th Cir. 1945).

The marketing of nonmembers' products through a member which is not a producer[9] exceeds the narrow range of activi-

[9] The Internal Revenue Service has permitted the marketing of nonmember-nonproducer items by an exempt cooperative without th duty to pay patronage dividends in certain emergency situations, such as when products supplied by members prove inadequate to fill outstanding orders. I.T. 1598, II-1 Cum. Bull. 159 (1923), *modified by* Rev. Rul. 70-319, 1970-1 Cum Bull. 284.

ties authorized by §521(b)(1) for an exempt cooperative organized and operated to market the "products of members or other producers." Accordingly, Land O'Lakes lost its exemption for the year 1963 because it undertook to market nonmember-nonproducer products.

III. *Deductions.*

In the district court, the Government contended that even if Land O'Lakes had qualified as an exempt farmers' cooperative in 1963, its deduction for patronage dividends to Northwest should be denied nonetheless. The district court allowed the deduction, holding that Northwest was a patron for purposes of §§1382 and 1388.

As we have already noted; an exempt cooperative may deduct amounts allocated to its patrons from sources other than patronage. 26 U.S.C. §1382(c)(2)(A). A nonexempt cooperative may not take this deduction. Because the district court did not consider Land O'Lakes' claim of this, as well as other, deductions in light of its status as a nonexempt cooperative, we remand the case to the district court for a determination of the deduction, if any, to which taxpayer is entitled as a nonexempt cooperative and a determination of Land O'Lakes' tax liability as a nonexempt cooperative.

Reversed and remanded for further proceedings.

A true copy.

Attest:

Clerk, U.S. Court of Appeals, Eighth Circuit.